KEYNOTE INTERVIEW

Alternative lenders step in to finance German recovery

Non-bank lenders are finally being compensated for risk in Europe's largest real estate market and have a crucial role to play in capital restructuring, according to PIMCO's Roman Kogan and PIMCO Prime Real Estate's Roland Fuchs

Elevated interest rates have created a difficult environment in Europe's largest real estate market. The VDP banking association recorded a 10.2 percent fall in commercial property prices in 2023 alone. But a first interest rate cut by the European Central Bank on 6 June brought a degree of relief, and alternative lenders are eyeing opportunities to deploy capital into the formerly bank dominated commercial real estate lending market as it recovers, say Roman Kogan, global co-head of PIMCO commercial real estate private lending, and Roland Fuchs, head of European real estate finance, PIMCO Prime Real Estate.

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Q How big a focus is Germany for your lending strategies?

Roland Fuchs: As the largest real estate market in Europe, Germany is one of our key markets. We have a core lending business which writes medium and long-term fixed rate loans. That has been the traditional sweet spot of alternative lenders, especially for insurance companies and pension funds entering the lending space in Europe.

But it is the transitional lending side that has grown most strongly over the past five years. That is a value-add type strategy providing short and medium-term loans, most of them floating rate in non-core situations. That higher cost of capital lending has previously been difficult to do in Germany because it has not produced the level of returns that non-bank lenders expect.

Q Germany is traditionally a bank dominated market. Why do you see opportunities for alternative lenders?

RF: Around 15 years ago the alternative lending sector in German was very small. In the following years insurance

companies, pension funds and asset managers began to widen their geographic spread outside the UK to cover Germany, attracted by the size of the market and its social and economic stability. That created a more diverse loan syndication market.

More recently, pension funds and insurance companies began to view lending as an attractive alternative method to equity investing to gain exposure to the real estate market. At the same time capital charges have created a ceiling on the balance sheet growth of the traditional lenders.

Roman Kogan: Changing banking regulation, particularly the migration away from internal based models of capital calculation to a more standardised approach has and will have a significant impact on the ability of banks to lend on commercial real estate. They have been reducing their footprint in the sector, and it will continue to become more and more economically unattractive for them as the rules continues to tighten.

RF: Germany still has one of the deepest, widest and most liquid banking markets in Europe. But it can no longer meet all of the needs for real estate lending, especially outside the traditional core sectors. That creates a stabilising complementarity between the still-active banking sector and the growing alternative finance market.

Q What role do you see non-bank debt capital playing in Germany's real estate market in the years to come?

RK: Alternative lenders have become a permanent fixture of the lending ecosystem. In the past, debt funds were usually mezzanine lenders targeting 10-12 percent returns. Now, they cover the full capital spectrum. For example, the PIMCO real estate platform can go from core fixed rate debt all the way to mezzanine for development, and everything in between. Borrowers have become more comfortable dealing with non-bank lenders. And banks have become more accepting of lending alongside us as part of a syndicate.

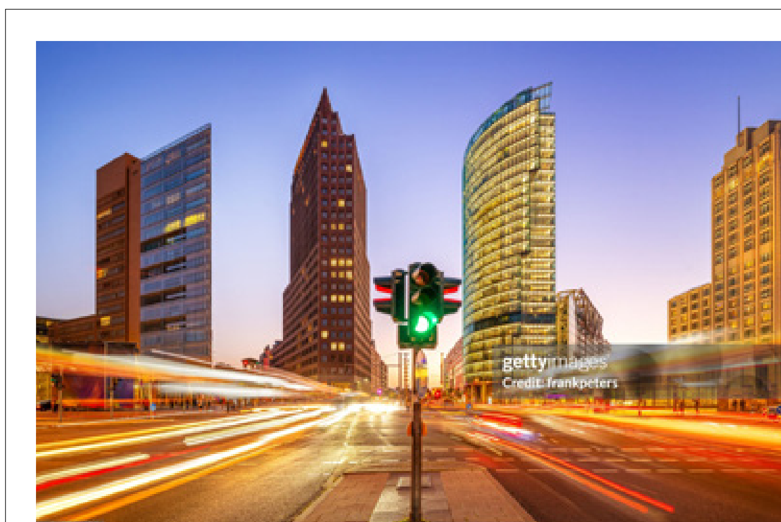
RF: Alternative lenders also bring to the finance market real estate expertise gained through equity investing. Meanwhile, the sector has become more ambitious, so it no longer sees itself as purely secondary ticket investors.

Our sponsors are often also our partners when buying and selling on the equity side, and we can build on those existing relationships. Typically, alternative lenders are financing assets that they also underwrite as equity investments. But by accessing them through credit they can do so at lower risk. For many years the risk-return profile of German real estate lending was unattractive. Now, because base rates are higher and margins have been adjusted, lenders are being better compensated for the risk they take.

When we look across our $110-plus billion private equity and lending book today, we see financing as the most attractive way for our investors to seek the returns they need from real estate, making those existing relationships particularly beneficial in today's markets.

Q Will refinancing maturing bank loans provide a major opportunity for alternative lenders?

RF: A lot of real estate equity was traded between 2015 and 2022, so there are refinancing opportunities, necessities,



Q What are the biggest challenges facing the German real estate market in the coming two years?

RF: The risks posed by political, social and economic volatility are relevant for all European markets, including Germany, and should not be underplayed. Nevertheless, real estate is a long-term play and in the German market we have many long-term asset holders, which have the cash, the liquidity, and the commitment to find solutions where necessary.

In Germany there is very little pressure coming from the CMBS side. There is no evidence of structural weaknesses that could trigger a distressed situation more than in other countries. If you look at the P&L (profit and loss) of the mortgage banks, landesbanks and commercial banks, higher interest rates have boosted interest income. That is a stabilising factor when they are seeking to make provision for any challenges that might emerge.

and sometimes challenges coming up. But there is capital available on the debt side, and on the equity side for deleveraging.

Germany has a broad investor community with deep pockets: pension funds, insurance companies and family offices. That is why we have not seen a lot of distress in the German market. Over the last 18-24 months there have been some intensive discussions. Refinancings have taken longer than previously. Investors need to be convinced not only that they are lending at the right leverage and margin, but also that borrowers have sound business and capex plans going forward, particularly for office loans.

RK: Capital structures need to be right sized. Because banks want typically lower LTVs there is a gap that needs to be filled, and for a lot of borrowers, it will be alternative lenders that provide the solution. That could be for all types of assets such as stabilised buildings, or for a recently completed development that needs refinancing to allow enough time for lease up and stabilisation.

Q Do you expect to see a significant wave of distress in Germany?

RK: Across all markets, the recognition that prices need to correct is there, so the market needs to absorb that emotionally and psychologically before transactions can happen. What may be particular to Germany is that it was the market at the tightest end of the cap rate and lending margin spectrum. The deep lending market helped to fuel those value increases so it may feel more pain than other markets as cap rates normalise. While there likely won't be a huge wave of distress, we are seeing some situations, particularly development projects, where funding gaps are emerging, and capital structures will need significant correction.

RF: In Germany there is a very specific cyclical opportunity because the development market has been over-leveraged. Write-downs will be necessary both on the equity and debt side in those situations. But because the market is still liquid there is capital willing to step in and restructure them. It may be wise not to step into those situations too quickly and aggressively, because price corrections typically take longer in Germany.

Q There are concerns about market conditions as property values recalibrate. How can lenders mitigate this risk when undertaking financing transactions?

RK: Since the GFC, the lending market has shown reasonably good discipline in its lending structures. Most loans reduce risk through structural features such as covenant protections. We have adjusted the metrics against which we lend. The debt yields that we would find acceptable have widened, and the LTV is a little bit lower. But that is an adjustment relative to market conditions and the changes we have seen in capitalisation rates.

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> **ROMAN KOGAN**

RF: To compensate for higher base rates, the minimum debt yields that you build in to cover potential volatility in your rent roll going forward also may need to be accordingly higher. The loans at 4 percent debt yields that we saw a couple of years ago will likely not be available anymore.

Q In which sectors in the German market do you see the most attractive conditions?

RK: We continue to see attractive opportunities in the industrial, logistics and living sectors, although that is not unique to Germany. Data centre assets have been a key focus area, and not just in the debt space. Digital infrastructure is PIMCO's highest-conviction area globally.

The major cities in Germany remain very strong office markets if you are backing the best-performing, ESG-compliant buildings that will attract tenant demand. Office repositioning can work for the right property, in the right location, with the right sponsor, with a credible business plan. In today's office market you need everything to be ideal, so those are difficult criteria to meet.

RF: If the sponsor has a clear vision for repositioning a centrally located asset in one of the major German office markets, you can potentially underwrite the loan with more confidence than you could for a core asset without such a compelling story.

People are still flowing into the cities of Europe and of Germany. They like to live, work and study in cities like Munich, Frankfurt, Hamburg and Düsseldorf. Those people need entertainment and services in locations which would formerly have been dominated by shopping centres. If an asset is meeting multiple customer needs and providing a great experience, then retail can be one of the most interesting and lively asset classes. But high-quality asset management and operational expertise are essential. ■

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